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OCT 1971
U.S.

IN THE

Supreme Court of the United States

OCTOBER TERM 1971

No. 1332

RELIANCE ELECTRIC COMPANY,
Petitioner,

v.

EMERSON ELECTRIC COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MOTION OF GULF & WESTERN INDUSTRIES, INC. FOR LEAVE TO FILE THE ACCOMPANYING BRIEF AS AMICUS CURIAE IN SUPPORT OF THE POSITION OF THE RESPONDENT

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MOTION OF GULF & WESTERN INDUSTRIES, INC. FOR LEAVE TO FILE THE ACCOMPANYING BRIEF AS AMICUS CURIAE IN SUPPORT OF THE POSITION OF THE RESPONDENT

Gulf & Western Industries, Inc. (hereinafter "Gulf & Western") hereby respectfully moves for leave to file the accompanying brief *amicus curiae* in this case. Attorneys for respondent have indicated that they neither consent to nor oppose the motion. The consent of the attorneys for the petitioner was requested but refused.

THE DECISION BELOW

The opinion of the court of appeals (App. 170-182) is reported at 434 F.2d 918. The opinion of the district court (App. 157-165) is reported at 306 F. Supp. 588.

The court of appeals held that the exemption for more than ten percent beneficial owners set forth in the text of Section 16(b) of the Securities Exchange Act of 1934, 15

U.S.C. 78p(b): (1) does not exclude the transaction by which a person previously unrelated to the issuer corporation acquires more than ten percent of a class of the issuer's shares; and (2) does exclude the second sale where such beneficial owner reduces his holdings below ten percent, and then sells the remainder of such shares.

THE INTEREST OF GULF & WESTERN INDUSTRIES, INC.

The interest of Gulf & Western arises from the fact that it is engaged as defendant in an action presently pending in the United States District Court for the Northern District of Illinois, Eastern Division, entitled *Allis-Chalmers Mfg. Co.* v. *Gulf & Western Ind., Inc.*, No. 70 C 513. In that action recovery is sought pursuant to Section 16(b) for alleged profits made by Gulf & Western in shares of the common stock of the plaintiff, "Allis-Chalmers", in connection with its acquisition of such shares pursuant to an exchange offer, and subsequent disposition thereof.

A central issue in that action is whether the purchase by which one becomes a more than 10 percent beneficial owner must, in all circumstances, be included under Section 16(b), in light of the statutory exclusion, "This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or sale and purchase, of the security involved. . . ." In that action, Gulf & Western concededly had no prior relationship with the issuer corporation before its initial purchase, made a single purchase of 3,000,000 shares by the exchange offer, and such acquisition and exchange offer were made in connection with full prospectus disclosure about the affairs of both Allis-Chalmers and Gulf & Western, as required pursuant to regulations promulgated under

the Securities Act of 1933.* Because Gulf & Western's initial acquisition involved 3,000,000 shares, the stake involved in that issue is clearly very great.

QUESTIONS THAT MAY NOT ADEQUATELY BE PRESENTED BY THE PARTIES

In the instant case, petitioner has restricted its argument to the question of whether a more than ten percent beneficial owner may reduce the amount of "automatic" liability he may potentially suffer under Section 16(b) by selling part of his holdings to reduce those holdings below 10 percent, and by selling the remainder of his holdings when he no longer occupies the status of the class of persons subject to the statute. If the issues and analysis in this case were so limited, Gulf & Western might have no interest in participating in this matter as *amicus curiae*.

However, the Securities and Exchange Commission ("SEC") has filed a brief *amicus curiae* which treats both ends of the transactions in question, and directly brings into issue the full scope and meaning of the statutory exemption as applied to both the initial purchase and both subsequent sales. In this way, the SEC apparently seeks the direct or indirect adjudication of an issue which clearly would not be a principal area of respondent's argument herein, if indeed it is advanced by respondent at

* Since Gulf & Western offered, in part, its own securities for Allis-Chalmers shares, it was required to do so pursuant to a registation statement and prospectus under the Securities Act of 1933: see 15 U.S.C. § 77(e). It was also required to secure and include therein information concerning the affairs of Allis-Chalmers, pursuant to Instruction F of the General Instructions for Form S-1 and Rule 409 promulgated by the SEC. Because Gulf & Western agreed to pay the expenses of Allis-Chalmers in providing the required financial information, the prospectus contained extensive treatment of Allis-Chalmers. It is conceded in that case that the prospectus complied with the federal law obligation of providing complete disclosure of material information, not misleading by reason of misstatement or omission.

all. This is so because respondent did not seek a writ of certiorari with respect to the initial transaction issue, and, we are advised, will address only the arguments made by the petitioner.

These circumstances present the danger that analysis in this case may proceed without challenge having been made to the treatment of the larger issue presented by the SEC. If the SEC's attempt to inject that issue and its view thereof were accepted, it will result in the practical prejudgment of that issue in the action in which Gulf & Western is engaged. Such a result, without benefit of trial, argument or judgment in that case, would most unfairly prejudice the litigation there. It would be unfair to preclude the trial court in *Allis-Chalmers* from deciding that case on its own merits. To cast a shadow on important issues in that case, by reflection here on a matter which was not presented by the parties, but originates only in the zeal of a governmental volunteer, would be patently unjust. Such prejudice can be avoided if the Court does not allow itself to be drawn into the decision of an important issue which is neither before it at the instance of the parties, nor the subject of their respective arguments. To guard against the possibility that the SEC might persuade the Court to adjudicate issues not tendered by the parties, we have requested permission to present our view of the construction of the statutory exemption involved. In our submission the theories offered by the SEC are fundamentally defective and unsupported by the legislative history of Section 16(b).

We propose to confine our analysis solely to the question of the initial ten percent transaction. Insofar as this issue may be deemed to be involved, despite the fact that it was not a subject of a petition for a writ of certiorari, our position supports the interest of the respondent, and would be dispositive of the case, regardless of the arguments presented on the "sale" end of the transactions.

For the foregoing reasons, we respectfully urge that Gulf & Western's motion be granted so that this Court may be informed of the countervailing considerations if it should extend its examination beyond the issues tendered by the parties.

Respectfully submitted,

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BRIEF IN SUPPORT OF THE POSITION OF THE RESPONDENT

JURISDICTION

The judgment of the court of appeals (App. 183) was entered on November 12, 1970. The petition for a writ of certiorari was filed on February 9, 1971, and was granted on April 5, 1971 (401 U.S. 1008). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the purchase by which a person with no prior relationship with the issuer corporation acquires more than ten percent of any class of securities of the issuer must, in all circumstances, be included as a transaction within Section 16(b), despite the statutory exemption stating that Section 16(b) should "not be construed" to cover such a transaction.

STATEMENT

We accept, and will not repeat, the statements of the case set forth by the petitioner, the respondent, and the SEC as *amicus curiae*.

STATUTE INVOLVED

Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), provides in pertinent part:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, * * * shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

ARGUMENT

SECTION 16(b) ACCORDS DIFFERENT TREATMENT TO OFFICIAL INSIDERS (OFFICERS AND DIRECTORS) THAN TO LARGE SHAREHOLDERS OF THE CORPORATION, BASED UPON A DISTINCTION WHICH ATTRIBUTES TO THE FORMER NOT ONLY KNOWLEDGE OF INSIDE EVENTS, BUT ALSO A CAPACITY TO MANIPULATE THE AFFAIRS OF THE CORPORATION TO CREATE EVENTS WHICH WILL AFFECT THE MARKET VALUE OF THE STOCK, AND ATTRIBUTES TO THE LATTER MERE ACCESS TO INSIDE INFORMATION. UNLESS SUPPLEMENTED BY OTHER PROOF, THE TRANSACTION BY WHICH A PERSON WITHOUT A PRIOR RELATIONSHIP TO THE ISSUER CORPORATION ACQUIRES THE STATUTORILY PRESCRIBED PERCENTAGE OF SHARES IS AND SHOULD BE EXCLUDED FROM SECTION 16(b)'s OPERATION.

1. The legislative history of Section 16(b) supports the aforesaid distinction between official and non-official insiders.

The present Section 16(b) did not experience a smooth journey in the legislative process. The original form of the section, embodied as Section 15(b) of Senate Bill No. 2693[1] and H.R. No. 7852,[2] provided in relevant part as follows:

> "It shall be unlawful for any director, officer, or owner of securities, owning as of record and/or beneficially more than five per centum of any class of stock of any issuer, any security of which is registered on a national securities exchange—

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1. Hearings Before the Senate Committee on Banking and Currency 73d Cong., 2d Sess. (1934), pp. 6556-6557 (hereinafter, "Senate Hearings").

2. Hearings Before House Committee on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess. (1934), p. 9 (hereinafter, "House Hearings").

> "(1) To purchase any such registered security with the intention or expectation of selling the same security within 6 months; and any profit made by such person on any transaction in such a registered security extending over a period of less than 6 months shall inure to and be recoverable by the issuer, irrespective of any intention or expectation on his part in entering into such transaction of holding the security purchased for a period exceeding 6 months."

No testimony was directed to the text of Section 16(b) in its present form during the legislative hearings, but was instead directed to the quoted text contained in the original bills. For reasons which will be explained below, the bills went through a number of changes in both houses, including changes relevant to the present problem.

The original form of the section contained no exemptive language. When the chief staff spokesman for the bill, Thomas G. Corcoran, appeared before the Senate Committee on Banking and Currency on February 27, 1934, two types of objections were raised by the Senate Committee members to the broad coverage of the bill.[3] The first was the advisability of having the bill operate against shareholders of the corporation who were not officers and directors. The following exchange occurred between Senator Kean and Mr. Corcoran (Senate Hearings, p. 6556):

> "Senator Kean. I think it is all right to apply it to a director or officer, but I think to require the ordinary investor—
>
> Mr. Corcoran. Five percent is a lot in a modern

3. Objections were also made to two omissions from coverage, later cured. The section was changed to permit the pairing of a sale followed by a purchase, (See Senate Hearings, p. 6557-8) and to correct an error making it appear that a director or officer would also have to hold 5% of the issuer's stock before he was subject to the statute. (See Senate Hearings, p. 6555)

corporation. Many corporations are controlled by 5 percent or 10 percent.

Senator Kean. They may own it or they may sell it. This applies to all corporations, and you are getting down to the point where you are interfering with the individual a good deal there. I agree with you with respect to the officers and directors.

Mr. Corcoran. A stockholder owning 5 percent is as much an insider as an officer or director. Whether he is a titular director or not, he normally is, as a practical matter of fact, a director.

Senator Kean. He might not be."

The second related to the general problem of the undesirable restrictions which might be placed upon fiduciaries in the administration of estates containing securities (Senate Hearings, p. 6558)—the problem to which the Brief of the SEC gives exclusive emphasis.

The staff draftsmen were apparently responsive to the second problem, but were unsympathetic to efforts to exclude shareholders from the statute's operation. Accordingly, a substitute Senate Bill No. 3420,[4] introduced on April 27, 1934 contained a provision giving generalized powers to the SEC to exempt transactions not comprehended within the purpose of the section, allowing room for the treatment of the problems of fiduciaries as well as other not immediately appreciable applications that might be undesired. And to meet the objections against making this automatic confiscation provision applicable to shareholders, the substitute bill raised the statutory ownership requirement from 5 percent of outstanding shares to more than 10 percent of such shares. This sequence makes clear that the provision giving the SEC such exemptive power was de-

4. Reprinted in Senate Report No. 792, 73d Cong., 2d Sess., p. 20 (1934).

signed to deal with, *inter alia*, the problems faced by fiduciaries, rather than, as now suggested by the SEC, that the 10 percent beneficial owner exemption was so designed.[5] For the latter provision was not included in any Senate draft.

On the other hand, the House draftsmen appeared more sympathetic to the problem of shareholders who did not become officers and directors, and in a revised bill (H.R. 8720, introduced on March 19, 1934) added not only a provision giving the SEC exemptive power, but also the exemption for 10 percent beneficial owners appearing in the statute as enacted. The House bill also added a preamble to the statute identifying its target not as the prevention of manipulation, but as the "unfair use of information" which "may have been obtained" by insiders by reason of a "relationship with the issuer."[6]

The significant difference between House and Senate attitudes toward this automatic recapture provision, reflected in part by its addition of the exemption for ten percent shareholders, is evidenced by subsequent events. Despite the additional exemptions contained in H.R. 8720, apparent hostility in the House to the automatic liability provisions resulted in the passage of a substitute bill, H.R. 9323, in-

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5. The SEC concedes that it has never relied, directly or indirectly, on the exemption for ten percent beneficial owners to resolve problems arising from the administration of trusts by fiduciaries. SEC Brief, p. 31. The alternate suggestion of the SEC that the exemptive provision was designed to deal solely with involuntary changes in ownership is obviously unsound. There is no support for this in the legislative history, and courts have handled the general problem of volition on an entirely independent basis. See, *e.g.*, *Ferraiolo v. Newman*, 259 F. 2d 342, 344-45 nn. 2, 3 (6 Cir. 1958), *cert. denied*, 359 U. S. 927 (1959).

6. The court of appeals, apparently relying upon a law review article, erroneously believed that the statutory preamble had been first introduced by S. Bill 3420, set forth in S. Rep. 792, 73rd Cong., 2d Sess. (1934). See 434 F. 2d 926, n. 21.

troduced on April 25, 1934, which contained no provision for automatic recapture of profits by either officers, directors or shareholders. In the version passed by the House, Section 16 would merely have required the reporting of transactions by insiders and contained the prohibition against short sales by insiders now appearing in Section 16(c) (the "anti-Wiggin" subsection).[7]

Because of the disagreement between H.R. 9323 as passed and the proposed Senate amendment thereto, the matter was referred to a committee of conference, which reported a conference bill containing the text of Section 16(b) in its present form, including the preamble added by the House, and *both* the exemption for ten percent beneficial owners previously proposed by the House, and the provision allowing for SEC exemption of transactions not falling within the statutory purpose.

Section 16(b) had been presented, first to the congressional committees, and then by the committees to their respective branches as a whole, as a special tool to combat the unfair use of inside information in short-term "speculative swings"[8] and, by reason of the House amendment, is so identified in its preamble. Nevertheless, there was a related problem which went beyond the use of inside information, and that problem was the manipulation of the affairs of a corporation to cause it to engage in activities which would affect the value of its stock favorably to the trading insiders. Its prevention is less clearly a target of Section 16(b), and it appears to have been brought into consideration in a somewhat backdoor fashion.

The Senate Committee on Banking and Currency, which was commissioned in 1932 to investigate stock market prac-

7. House Report No. 1383 on H.R. 9323, 73d Cong. 2d Sess., p. 3, 24 (1934).

8. See Senate Hearings, p. 6557.

tices, concentrated its efforts on the large trading pools through which manipulators had sought to create false activity in the shares in which they were trading, often granting option interests to exchange members to encourage their cooperation in these and similar efforts.[9] These abuses were quite different from the abuses claimed by the spokesman to require the passage of Section 16(b) and were met by specific prohibitions in Section 9, and more generally, Section 10, of the 1934 Act. But when, after the 1934 Act had been passed, the Committee staff was called upon to report the evidence developed in its investigations, the staff writers of the Senate reports made derivative use of the materials developed in connection with the aforesaid manipulative practices, confusing to some extent the issues of use of inside information and that of manipulation of corporate affairs.[10]

Although these materials without exception showed officers and directors rather than shareholders directing these abusive trading practices,[11] it is nevertheless true that at least one prior report reflected the same confusion between informational and manipulative abuses. Thus, one example set forth in Senate Report 792, which accompanied Senate Bill 3420, suggested that certain directors participating in a trading pool had engaged in the manipulation of dividends to benefit the trading pool (S. Rep. 792, p. 9). On the basis of this legislative history, it might be argued that

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9. See Senate Report No. 1455, 73 Cong., 2d Sess., pp. 1-4 (1934).

10. See Senate Report No. 1455, entitled "Stock Exchange Practices," 73d Congress, 2d Sess. (1934); compare pp. 29-54 with pp. 55-68. This report was issued on June 16, 1934, after the conference bill was reported and passed. Although it is instructive as to the investigations conducted by the Pecorra committee, it was not a report which may properly be used to evidence the intent of Congress in the passage of the bill since it followed its passage and purports to represent only the views of the Senate Committee.

11. *Ibid.*

this type of manipulative practice was also an object of S. Bill 3420. And since S. Bill 3420 made no distinction between official and non-official insiders, it could be claimed that both official and non-official insiders alike were presumed to have had manipulative ability as opposed to mere informational access. However, S. Bill 3420 did not become law. Rather, the conference bill which was passed by both houses and which reflected the narrower position of the House, did specifically give different treatment to official and non-official "insiders". It is on the basis of this distinction in imputing manipulative ability that the statutory exemption has been, and most plausibly can be, explained. *Adler* v. *Klawans,* 267 F.2d 840 (2 Cir. 1959).

Section 16(b) was presented to the Congress as a device designed to reach directors, officers, and large shareholders "speculating . . . on the basis of information not available to others" and more specifically, trading in the stocks of their own companies "with the benefit of *advance information.*"[12] Spokesmen in committees, testifying with respect to Senate Bill No. 2693 (the original bill), described its target as instances where insiders bought stock with inside foreknowledge of information which, when released, would cause a rise in the value of the stock, and then sold upon the rise; and the reverse situation, where insiders sold stock with foreknowledge of information which would cause a decline in the value of the stock, and repurchased when the decline occurred.[13] In the text of the original bill, the target was the purchase of a security "with the intention or expectation" existing at the time or the purchase "of selling the same security within six months", although, of course, such expectation need not be proved.

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12. Senate Report No. 792, 73d Cong., 2d Sess., p. 9 (1934). (Emphasis added.)

13. Senate Hearings, pp. 6557-6558.

Obviously, unless inside information can be presumed to exist at the time the initial transaction is effected, there is no statutory basis for presuming an "intention or expectation" later to dispose of the shares. And because there is no statutory "relationship with the issuer" until the requisite ten percent purchase has been made, there is no basis for presuming it was made on the basis of inside information. This has been noted by the Second Circuit in *Newmark* v. *R.K.O. General, Inc.*, 425 F.2d 348, 356 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970), as follows:

> "[T]his presumption would not justify the conclusion that one who purchases a quantity of shares which makes him a ten percent beneficial owner has done so on the basis of inside information . . ."

In short, if the only circumstances in a case were that the ten percent beneficial owner had become such in a transaction which he entered "blind"—that is, without the "relationship with the issuer" which is a prerequisite to the presumption of inside information—he would be in no position to undertake the "speculative short swing" at which the statute was aimed, and accordingly there should be no "automatic" liability. Note, 70 Harv. L. Rev. 1312, 1313 (1957).

Because there is no exemption in the statute for officers and directors, it follows that there must be a difference between the presumed capacities of official and shareholder insiders to support a difference in treatment. This was explored by the present Chief Justice[14] writing for a unanimous court in *Adler* v. *Klawans, supra*, 267 F.2d 840. There the defendant bought shares, became a director of the corporation, and then sold his shares within six months of purchase. Upon becoming a director he successfully

14. Sitting by designation pursuant to 28 U.S.C. § 291(a).

moved for the declaration of an unusual cash and stock dividend, and in addition he moved for the repurchase by the issuer corporation of some of its outstanding shares. Both acts would have had the effect of raising and supporting the price of the stock. Immediately thereafter, the director began selling his own shares. In holding the director liable, although he had bought the subject shares before he became director, the court based its holding upon very distinct reasoning:

> "Our primary holding simply gives effect to the statutory mandate which presupposes that, at some moment before making a sale of stock, the insider was in an *official position* which he *could have used to influence* the sale price. (*Supra,* 267 F.2d 845.)" (Emphasis added to emphasis in original) 267 F.2d at 848.

The court, in short, gave effect to the residual target of Section 16(b)—the manipulation of corporate affairs to produce a change in the value of the stock. But in extending the statute to this less certain target, the court drew a clear line between officers and directors on one hand and ten percent beneficial owners on the other:

> "There is, of course, a logical and practical basis for distinction. Generally, although there are important exceptions in certain circumstances, officers and directors have more ready access to the intimate business secrets of corporations and factors which can affect the real and ultimately the market value of stock than does even so large a stockholder as a '10% beneficial owner.' This is not to discount the potential influence of the [mere shareholder] but simply to acknowledge the basis for the different treatment accorded them by Congress. Moreover, a director or officer can usually *stimulate more directly*

> *actions which affect stock values* and might have knowledge of factors which might depress values. . . . Beyond doubt it was considerations of this character which led Congress to make a provision concerning 10% owners which was not made with respect to officers and directors. It is found in the following language: [quoting the statutory exemption]." (Emphasis added) *Adler* v. *Klawans, supra,* 267 F.2d at 845.

We believe that this distinction accurately reflects the compromise finally reached by the House and Senate conferees with respect to the treatment of shareholders. Clearly, it is one thing to presume that a large shareholder has sufficient footing with management to receive reports of confidential information, and it is quite another to presume that a statutory beneficial owner can manipulate corporate policy. Indeed, the facts of the instant case, if nothing else, negative that type of unwarranted assumption. And the proposition may be put in more general terms. An officer or director has a direct and inherent responsibility to exert influence upon the conduct of his company's affairs and to apprise himself of all relevant information. He is expected to use these for the corporation's benefit, but as the legislative history of the 1934 Act demonstrates, he may not. A shareholder, on the other hand, clearly has no such function, and may in fact *never* have any access, informational or otherwise, to the company's management.

This distinction between the presumed manipulative abilities of official and non-official insiders explains the statutory exemption. For if one possesses manipulative ability, he can create a profit even though his purchase of shares was made without inside information. Thus, directors and officers may be charged for such transactions, whereas, under the exemptive language, a shareholder may not—

unless, as explored in Point 3, *infra,* other facts give reason for deciding otherwise. Resolution of this problem on the basis of this distinction yields logical results. As demonstrated in the following section, the theories proposed by the SEC do not.

2. The reasons offered by the SEC for charging the transaction by which one becomes a ten percent beneficial owner are unsound.

At pages 23 to 25 of its brief the SEC suggests three reasons for charging the initial ten percent transaction. Each is fundamentally deficient.

First, it is suggested that a person who becomes a ten beneficial owner by the purchase of a large block of shares may have obtained inside information prior to the purchase through negotiations for the purchase. This theory is contrary to the structure of the statute itself, which conditions a presumption of inside information upon the existence of a statutorily defined "relationship with the issuer." Such a theory has twice been rejected by the Second Circuit.[15] And it seeks impermissibly to force additional presumptions onto those already in the statute. See *Blau* v. *Lehman,* 368 U.S. 403, 413-414 (1962). There is

15. Participating as *amicus* in *Stella* v. *Graham-Paige Motors Corp.,* 104 F. Supp. 957 (S.D.N.Y. 1952), *aff'd in part and remanded in part,* 232 F. 2d 299 (2 Cir.), *cert. denied,* 352 U.S. 831 (1956), the SEC urged the same "information before ownership" argument as a basis for liability. Memorandum for the Securities and Exchange Commission, March 1952, pp. 5-6. Neither the district court nor the circuit court would accept this ground, basing liability in that case on the problem of repetitive inside ownership. See 104 F. Supp. at 957; 232 F. 2d at 300-301. This case is discussed *infra* at p. 26. In *Newmark* v. *R.K.O. General, Inc., supra,* the same court noted that the premises of Section 16(b) will not justify a presumption that one who purchases more than ten percent of an issuer's outstanding shares has done so on the basis of inside information. 425 F. 2d 348, 356.

nothing in Section 16(b) that requires or invites a court to presume that a prospective purchaser of shares has bargained with the issuer either for the shares or for confidential disclosures, when he can as easily acquire shares on the open market, or as in this case through a nationally publicized tender offer, or as in the Gulf & Western litigation, through a national exchange offer made by prospectus.

Second, the SEC urges that a person may purchase a large block of shares with the intent to engage in manipulative practices to raise the value of the shares after he has become an insider. As the aforesaid legislative history set forth in Point 1, *supra,* demonstrates, Section 16(b) was not primarily designed to counter manipulation, and to the questionable extent that it does so, it attaches "automatic" liability only to officers and directors, not making an arbitrary presumption of manipulative ability in the case of ten percent beneficial owners. *Adler* v. *Klawans, supra.*

Third, it is urged that regardless of a purchaser's intent, he could, subsequent to the purchase, manipulate the affairs of the corporation and obtain inside information. Since intent is irrelevant under Section 16(b), this third suggestion is the same as the second, insofar as claimed manipulation is concerned, and does not present an additionl argument.

To the extent that the SEC's "third" reason contains the suggestion that Section 16(b) should apply because a ten percent purchaser could theoretically obtain information *after* the purchase which he could use in selling the stock, it raises the substantial question of whether presumed use of after-acquired information—that is, information relevant solely to one-half of an alleged short-swing transaction—is an abuse contemplated by Section 16(b). This

same theory was suggested in *dictum,* in *Newmark* v. *R.K.O. General Corp., supra,* 425 F.2d at 356, where it was argued that "the presumed access to such [subsequent] information resulting from this purchase provides him with an opportunity, not available to the investing public, to sell his shares at the moment most advantageous to him."

We submit that application of Section 16(b) on the after-acquired information theory is a clear and impermissible extension of the statute beyond its purpose, and that the theory is demonstrably unsound.

First, it is clearly beyond the scope of the statute which the Congress intended to enact, and this is evidenced by the aforesaid legislative history. If liability is imposed merely upon the possibility of after-acquired information, then the aim is no longer to reach the trader who had a present "intention or expectation" at the time of the purchase to dispose of the securities within 6 months or to attack those who engage in a speculative short swing "*with advance information.*" It is an extension of the statutory purpose. Yet the clear teaching of this Court in the only case in which it has previously considered Section 16(b) was that so arbitrary a mechanism should not be expanded beyond the narrow range of its application. *Blau* v. *Lehman, supra,* 368 U.S. 403, 411-412.

Second and, we submit, conclusive is that such a theory yields analytically unsupportable results. Its premise is that after a purchaser has become a ten percent owner, his presumed access to inside information will allow him to sell at a time and price more "advantageous" than that available to an "outside" shareholder—*i.e.*, in advance of a less favorable price for the stock due to negative (or static) prospects for the corporation's business not publicly known at the time of the sale. If the insider does so sell on the basis of his presumed information, his advantage

or "profit" over an outside investor is that he unfairly saves to himself the difference between his sale price and the price he would have received if he, like any other member of the public, had held his stock and disposed of it at some less favorable time. In other words, the unfair "profit" is his actual sale price minus some other and lesser sale price on the stock. But Section 16(b) simply cannot measure such a profit. For if Section 16(b) were applied, the insider would be charged instead with the difference between his prior purchase price and his sale price.

This is a result which bears *no relationship* whatsoever to the insider's profit, if any, by the use of inside information. This is demonstrated in the margin.[16] The defendant will consistently be charged with either less than or more than the profit resulting from his presumed use of inside information. Such a result is unsupportable, not merely because it has no relationship to the insider's possible use of inside information, but further because there is no possibility of such a relationship, except in the improbable coincidence

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16. The results of the aforesaid theory are readily demonstrated by two hypothetical cases which assume *arguendo* actual use of inside information, within the range of the prototype suggested.

X, having no prior relationship to the corporation, buys more than 10% of its shares in the presumptively innocent transaction at $20 per share. In the succeeding months the stock rises to $50. In the fifth month he learns on an "inside basis" that earnings will be lower than predicted and sells his shares at $50. When the news is announced, the stock drops to $45. Although he has clearly gained an unfair advantage of $5 over a public investor, the SEC's theory would charge him with a $30 advantage. Yet $25 of the increment has *nothing* to do with any use of inside information, actual or potential.

Or take the converse situation: X's initial and presumptively innocent purchase is made at $22 per share. In the succeeding months the price rises to $25 per share. In the fifth month X learns that the corporation's main product line has a serious safety defect, and sells his shares at $25. When the news is announced the stock drops to $10 per share. Although X has gained an unfair advantage of $15 over a public investor, the SEC's theory will charge him with only $3.

that the increase in value of the securities during the insider's holding period precisely equalled the difference in sale prices. The theory, in short, yields an absurd result—and such a result should not be ascribed to the 73rd Congress as having been intended by it.

What is shown quite clearly is that Section 16(b) is *inherently structured* so that it can measure "profit" only from the date of purchase to the date of sale, or vice-versa. This alone indicates that the purchase itself must be infected with presumable abuse. *Otherwise both the price of purchase and the very fact that there was a recent purchase are stripped of relevance.*

This problem was the subject of treatment in a recent commentary, which illustrates the logical defect of the after-acquired information theory.

> "[I]t appears undesirable to apply section 16(b) to a situation where there is no possibility the insider could have had inside information when he made his original purchase (or sale). *Cf. Stella* v. *Graham-Paige Motors Corp., supra* (Hincks, J., dissenting). In such situations, although the later sale (purchase) may be made on the basis of inside information, *the unfairness is independent of whether the two transactions were made in conjunction with each other* as section 16(b), which speaks in terms of 'purchase and sale' and 'sale and purchase,' seems implicitly intended to require. *It is actually a single-transaction abuse where Section 16(b) is brought into play only because of the mere happenstance that the original purchase (sale) took place less than six months earlier.* It would be preferable to treat such situations under the general anti-fraud provisions of the Securities Exchange Act, § 10(b), 15 U.S.C. §78j(b) (1964) and Rule 10b-5 thereunder, 17 C.F.R. §240.10b-5 (1968)." (Emphasis added).

Stock Exchanges Pursuant To Corporate Consolidation: A Section 16(b) "Purchase or Sale"?, 117 U. Pa. L. Rev. 1034, 1042 n. 39 (1969).

And in *Blau* v. *Lamb*, 363 F.2d 507, 522-23 n. 22 (2 Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967), the Second Circuit, responding to an argument that because an insider could engineer a high dividend and then convert his stock to obtain it, a conversion should be treated as a chargeable transaction under Section 16(b), said:

> "The difficulty with this argument is that the danger exists independently of short-term trading by controlling insiders in their issuer's stock. For example, in the stated hypothetical, precisely the same opportunity for abuse would exist if the insider had held the convertible security for more than six months."

Precisely the same difficulty exists with the after-acquired information theory.

Under the after-acquired information theory the only conceivable abuse lies between two possible sale prices—a "profit" which Section 16(b) is not capable of measuring. It contemplates, in short, an alleged wrong with which Section 16(b) was not meant to deal, but for which Section 10 and Rule 10b-5 promulgated thereunder were.[17] "[O]ther

17. If an insider, after the presumptively innocent first transaction, thereafter acquired inside information—that is, learned news affecting the value of the stock—and sold at a time before the news was publicly released, plaintiff's task in remedying this abuse is heavily aided by statute. Even though the insider is not liable under Section 16(b), he must still report both his purchase and sale under Section 16(a). Reports filed under 16(a) are published regularly in financial newspapers. The potential plaintiff will immediately be aware of the transaction. Moreover, in the most likely situation there will be a specific event which, when announced, will cause a devaluation of the stock. In this circumstance both the private plaintiff and the SEC will know of both such event and the insider's transaction, laying the foundation for a very good case pursuant to Rule 10b-5 promulgated under the Act. The application of Rule 10b-5 obviously *will* yield profit liability related to the possible abuse. See generally Lowenfels, *Section 16(b): A New Trend in Regulating Insider Trading*, 54 Cornell L. Q. 45, 61-64 (1968).

remedies are then available but only on proof of actual wrongdoing."[18]

The SEC nevertheless urges that possible use of after-acquired information should support automatic liability because it claims that the preamble to the statute, designating its target as the "unfair use of information," suggests a "broad" application (SEC Brief, p. 25). As indicated at pages 10-11, *supra,* the legislative history suggests that the preamble was inserted by the House to narrow the scope of the statute. Thus, in a related context, the Ninth Circuit noted:

> "As section 16(b) itself states, its general purpose is to preclude the 'unfair use of information which may have been obtained by' corporate insiders, trading in securities of their corporation. But Congress did not seek to accomplish the whole of this purpose by section 16(b) alone. *Section 16(b) creates a special remedy, applicable only in a limited situation.*" (Emphasis added.) *Blau* v. *Max Factor & Co., supra,* 342 F.2d 304, 307.

The third defect in the after-acquired information theory is that its rationale does not relate in scope to the statutory exclusion it purports to explain. For example, if the purchaser had acquired a small number of shares before its ten percent purchase, and later disposed of these same shares along with the shares acquired in the ten percent purchase, it would be universally conceded that no claim could be made that the sale of the earlier acquired shares should be chargeable under Section 16(b).[19]

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18. *Blau v. Max Factor Co.,* 342 F. 2d 304, 307 (9 Cir.); *cert. denied,* 382 U.S. 892 (1965).

19. See *Adler v. Klawans, supra.*

But under the after-acquired information theory, those shares are analytically identical to the shares acquired in the ten percent purchase, for the supposed after-acquired information would be equally relevant to their disposition. In short, the after-acquired information theory cannot be the rationale for including the initial transaction, for it would reach transactions which are concededly excluded by the statutory exemption, and therefore the theory obviously does not comport with the operation of the very statutory exemption which it purports to explain.

3. The rule should be that the transaction by which a person acquires more than 10 percent of a corporation's outstanding shares may or may not be charged under Section 16(b), depending upon whether the operative facts show the reasonable possibility of an abuse which the statute was designed to remedy.

Although Section 16(b) has been the victim of overly broad decisional language, in the past decade the courts of appeal and district courts have taken pains to avoid the overkill that might have resulted from thoughtless adherence to the language of older cases, without, however, diluting the true purpose of the statute.[20] Thus, for ex-

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20. See, *e.g., Chemical Fund, Inc.* v. *Xerox, Inc.*, 377 F.2d 107, esp. 111n. 7 (2 Cir. 1967); *Pettys* v. *Butler*, 367 F.2d 528 (8 Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); *Ferraiolo* v. *Newman*, 259 F.2d 342 (6 Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); *Cf. Mueller* v. *Korholt*, 1971 CCH Fed. Sec. L. Rep. ¶93,222, p. 91,404 (7 Cir. 1971); *Alloys Unlimited* v. *Gilbert*, 319 F. Supp. 617, 619 (S.D.N.Y. 1970).

ample, in *Blau* v. *Lamb, supra,* 363 F.2d 507, 517-519. Judge Waterman carefully noted that the dogmatic language appearing in *Park & Tilford, Inc.* v. *Schulte,* 160 F.2d 984 (2 Cir.), *cert. denied,* 332 U.S. 761 (1947), went unnecessarily beyond the needs of that case, while the actual decisions of the circuit and district courts reflected an analytical approach to the questions presented by Section 16(b). The same problem of overly broad decisional language has, to date, hindered analysis of the exemptive clause under consideration.

Contrary to the recital set forth in the SEC's Brief at p. 21, the question of whether the exemptive clause applies to the transaction by which a purchaser acquires more than ten percent of a class of shares has been raised as a defense by a Section 16(b) defendant in only three cases: *Stella* v. *Graham-Paige Motors Corporation,* 232 F.2d 299 (2 Cir.), *cert. denied,* 352 U.S. 831 (1956) (defense denied); *Allis-Chalmers Mfg. Co.* v. *Gulf & Western Industries, Inc.,* No. 70-C-513 (N.D. Ill.) (motion to strike defense denied); *Arkansas Louisiana Gas Co.* v. *W. R. Stephens Investment Co.,* 141 F. Supp. 841 (W.D. Ark. 1956) (defense allowed). The issue was unnecessarily treated in *dictum*[21] in *Newmark* v. *R.K.O. General, Inc., supra,* 425 F.2d at 355-356, and in *Abrams* v. *Occidental Petroleum Corp.,* 323 F. Supp. 570, 579 (S.D.N.Y.), *appeal argued and decision pending,* the issue was not raised by the defendant.[22] Every other case cited by the SEC either contains no reference to the problem or mentions the problem in passing *dictum.* And with two

21. See pp. 29-30, *infra.*

22. See Reply Brief For Defendant-Appellant, *Abrams* v. *Occidental Petroleum Corp.,* Nos. 71-1273-4-5-6 (2 Cir.), pp. 30-33.

exceptions, every case touching upon the problem was a case decided by a court within the Second Circuit, which is bound by the rule laid down in *Stella* v. *Graham-Paige Motors Corp., supra.*

These two exceptions, significantly, are cases where the defendants were not mere shareholders, but officers and directors. *Bershad* v. *McDonough,* 428 F.2d 693 (7 Cir. 1970) (defendants were a director and his wife whose joint holdings controlled the corporation); *Gold* v. *Scurlock,* CCH Fed. Sec. L. Rep. ¶93,021 at 90,770-90,771 (E.D. Va. 1971) (defendants were officers and directors in the corporation involved in the merger in which the shares "purchased" were received). In short, prior to the decision of the court below, there was only one court of appeals apparently committed to a rule which, at least in verbiage, required the inclusion of the initial ten percent transaction.

The difficulty with *Stella* v. *Graham-Paige Motors Corp., supra,* is that it, like *Park & Tilford, Inc.* v. *Schulte, supra,* was a case properly decided but done so in unnecessarily broad terms. The basis for the decision was expressly to deal with the problem of *repetitive* inside association,[23] in circumstances which gave compelling indications of access to inside information *before* the "initial purchase" so charged. In fact, the transaction was defendant's second, not first, inside association with the issuer corporation ("Kaiser-Frazer").

The purchase in question occurred in February, 1947.[24] Kaiser-Frazer had been formed in 1945, only two years

23. 104 F. Supp. at 959. The Second Circuit, in affirming, merely adopted the reasoning of the district court without discussion. 232 F.2d at 300-301.

24. The following facts are recited at 104 F. Supp. 957, 958.

before that date, and fully half of its shares were acquired by the defendant, the other half by interests controlled by Henry J. Kaiser. Thereafter the relationship of defendant "Graham-Paige" and the issuer continued, and defendant's massive holdings were reduced not by any affirmative disconnection between the two, but by the passive dilution of the percentage of its holdings due to further public offerings of stock. The first offering in September, 1945, reduced defendant's holdings to 11.34%. In January, 1946, an additional offering was made and defendant's holdings were reduced to 6.25%. During the same period, the holdings of the co-founder Kaiser were reduced to 9.25% of the shares outstanding, Kaiser having made several purchases in the interim. At the time of its February, 1947 purchase, defendant still held over 6.25% of Kaiser-Frazer's shares, and that purchase increased its holdings to 21%. Not only was there a continuing relationship, but the purchase of February, 1947 was that of an "outsider" only in form. It was uncontradicted that the purchase was:

> "in pursuance of [a prior] agreement under which these shares were placed in the voting trust of which Kaiser and Joseph W. Frazer, an officer of Graham-Paige, were the voting trustees."[25]

Thus, the purchase was in pursuance of a private agreement between the defendant and the co-organizer, whose combined holdings before the purchase amounted to 15.75% of the corporation's shares, and whose combined holdings, according to the prepurchase agreement, were to be placed in a voting trust after the purchase had been effected.

It should be noted that the defendant never argued that under the facts of the *Stella* case, Section 16(b) should not reasonably apply, but merely rested on the technical argument, that in light of the proviso noted, Section 16(b) could

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25. *Ibid.*

never apply to an initial transaction, no matter what the factual circumstances.[26]

Using the facts of *recurrent* "inside" ownership in the case before it as a model, the district court in *Stella* posed a hypothetical situation which led it incorrectly to a rationale that Section 16(b) *always* includes the initial transaction. It believed that if Section 16(b) could not apply to a holder of shares who did not own more than ten percent before a transaction, then:

> "It would be possible for a person to purchase a large block of stock, sell it out until his ownership was reduced to less than 10%, and then repeat the process, ad infinitum."

104 F. Supp. 957, 959. The difficulty with such a theory[27] is that it has no application to a case where there has been no repetitive "inside" status. *Cessante ratione legis, cessate et ipsa lex.* In addition, it is clear that both on the facts

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26. The formulation of the issue in the *Stella* case, and the absolutist theories upon which the parties, the majority, and the dissent therein proceeded obviously reflected the state of Section 16(b) analysis at that time, which was referred to as a "crude rule of thumb" approach. Since that time, in a number of cases cited throughout this brief, courts have resolved problematical areas of coverage on the basis of whether the peculiar facts allowed for the type of abuse at which the statute was directed. See, *e.g., Blau* v. *Lamb, supra,* 363 F.2d at 517-520 and cases cited *supra,* n. 20.

27. Authorities supporting the holding in *Stella* are 2 Loss, *Securities Regulation* 1060 (2d ed. 1961); Cook & Feldman, *Insider Trading Under the Securities Exchange Act,* 66 Harv. L. Rev. 612, 631-632 (1953); both of which rely upon the hypothetical problem set forth in the text.

Other commentators were quick to point out that the rationale of the hypothetical posed by the district court in *Stella* was not sufficient to justify an absolute rule. *See* Munter, *Section 16(b) of the Securities Exchange Act of 1934: An Alternative to Burning Down the Barn in Order to Kill the Rats,* 52 Cornell L. Q. 69, 75 (1966), *and see* Note, 70 Harv. L. Rev. 1312, 1313 (1957), approving the result in *Stella,* but observing that the court reached an unreasonably broad statement of application of the statute, beyond the needs of the hypothetical; see also Painter, *Federal Regulation of Insider Trading* (1938), pp. 41-42; Note, 84 Harv. L. Rev. 1012, 1022-3, n. 30 (1971); Note, *Short-Swing Profits and the Ten Percent Rule,* 9 Stan. L. Rev. 582, 587 (1967); Note, 44 Marq L. Rev. 64-65 (1960).

in *Stella* and on the rationale developed on the basis of the hypothetical, the underlying theory for charging the initial transaction was the probability, based on special facts, that an inside relationship existed *before* the transaction was effected.

Following the decision in *Stella,* commentators indicated that the rationale on which the court had imposed liability was insufficiently broad to justify charging the initial ten percent transaction in every case.[28] The Second Circuit apparently noted the defect. When the issue next arose, in *Newmark* v. *RKO General, Inc., supra,* the court merely cited, but did not repeat, the rationale of *Stella.* In language that was not related to the problem posed by the facts of *Newmark,* and which was clearly *dictum,* the court set forth the after-acquired information theory noted and discussed at pp. 19-24 *supra.* See 425 F.2d at 355-356.

The *Newmark* case, however, in no way involved the exploitation of after-acquired information. Rather, both the court of appeals and the district court explicitly found that the defendant "RKO" in fact had and used inside information before it purchased the shares involved. This information concerned a proposed merger between an airline it controlled ("Frontier") and another airline ("Central"). RKO contracted to purchase the Central shares involved before such information had been made public (249 F. Supp. 351). The circuit court found that:

> "RKO's contract to purchase Central shares is a classic example of trading while in the possession of information unavailable to the general public." 425 F.2d at 353.

In addition, the court expressly held that RKO had become a beneficial owner of more than ten percent of

28. See preceeding footnote.

Central's common stock *before* it purchased Central shares. 425 F.2d at 356. Before it took the investment risk of purchasing the Central shares, RKO had contracted to purchase such shares at a fixed price under an agreement which not only insured that the issuer, Central, would be managed in RKO's interest and required controlling Central shareholders to vote for the merger, but also in effect gave RKO the right to abandon the merger and the purchase of the shares if the merger turned out to be a less lucrative prospect than RKO desired. 425 F.2d at 353-354.

Thus it is appropriate to characterize as "dictum" the statement in the *Newmark* case as to the permissibility of attaching a later sale to a presumptively innocent initial purchase on the basis of the exploitation of after-acquired information, for the language had no bearing on the case then before this Court. There was no innocent initial transaction involved under the *Newmark* facts. Rather the case before the court was an archetypal example of an insider, with presumable and actual foreknowledge before its actual purchase, making that purchase with a view toward later disposition in a merger over which it retained control.

Thus, neither *Stella* nor *Newmark* provides any basis for the automatic inclusion of and extraction of profits from a transaction which results in an outsider becoming a more than ten percent beneficial owner. In the only case in which the issue arose in circumstances devoid of the countervailing facts which existed in the two Second Circuit cases, the court refused to charge the initial ten percent transaction. *Arkansas Louisiana Gas Co.* v. *W. R. Stephens Invest. Co., supra,* 141 F. Supp. 841, 847.

We do not seek or propose an absolute rule which would *always* exclude the initial transaction (as proposed by

Hincks, J., dissenting in *Stella* v. *Graham Paige Motors Co., supra,* 232 F.2d 299, 302-305). We do oppose a rule which, regardless of whether the purpose of the statute would be served, would *always* include the initial transaction. Liability should properly be found in cases of repetitive ownership (*Stella*), simply because the danger that the statute could otherwise be subverted is too great. And liability may properly be found in a case where the defendant, also as in *Stella,* had substantially an insider's relationship before the transaction in question. Equally sound in result is *Newmark* v. *RKO General, Inc.,* where the defendant not only purchased on the basis of inside information, but acquired a right to buy the shares before taking the investment risk of doing so, and then retained control over the merger—the event that would, if RKO so wished, lead to their disposition at a profit. Such a studied approach strikes at all the abuses for which Section 16(b) was designed. Equally important, it does not extend the range of the statute to situations to which it was not intended to apply.

We submit that such an approach has been prescribed by this Court in a closely analogous area. In *Blau* v. *Lehman, supra,* 368 U. S. 403, one Thomas, a partner of the investment house of Lehman Brothers ("Lehman") was a director of and thus an "insider" of Tidewater Associated Oil Company ("Tidewater"), having succeeded another Lehman partner on Tidewater's board. While Thomas was thus a director-insider, Lehman bought and sold Tidewater securities at a profit, Thomas disclaiming interest therein. Sections 3(a)9 and 3(a)7 of the 1934 Act permitted construing the word "director" in §16(b) as including a partnership such as Lehman,[29] although it did not so require. 368

29. See 286 F.2d at 794; 368 U. S. at 415.

U. S. at 410. Both plaintiff and the SEC argued that Lehman should be automatically treated as an insider and thus be held liable for all of the profits in Tidewater transactions, or alternatively that Thomas should be held liable for all of Lehman's profits. Their argument was characterized by the Court as follows:

> "Failure to do so, it is argued, will leave a large and unintended loophole in the statute—one substantially eliminating the great Wall Street trading firms from the statute's operation." (368 U. S. at 411).
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> "'[O]nly by holding the partner-director liable for the *entire* short-swing profits realized by his firm' it is urged, can 'an effective prophylactic to the stated statutory policy . . . be fully enforced'." (*Id.* at 413).

The SEC thus contended for a rule imposing liability upon Lehman without further proof. *Ibid.* This Court rejected these arguments, stating:

> "But liability under § 16(b) is to be determined neither by general partnership law nor by adding to the 'prophylactic' effect Congress itself clearly prescribed in § 16(b)." (*Id.* at 414).

Instead, this Court recognized the propriety of inquiry into the question of whether Lehman had in fact "deputized Thomas to represent its interests as a director of Tidewater," *id.* at 408, and affirmed the lower court's findings that Lehman had not so "deputized" Thomas.

Here, the statutory exemption, as noted by the court below, has repeatedly been termed "ambiguous" (434 F.2d at 922). We believe that the legislative history of the statute renders the purpose of the exemption far less "ambiguous"

and does so in respondent's favor. To the extent that uncertainty may remain in the construction of the exemption, *Blau* v. *Lehman, supra,* clearly holds that in areas in which coverage of Section 16(b) is questionable, coverage should not be arbitrarily resolved against a defendant as if it were not questionable. Rather, to the extent that there is flexibility in the language of the statute, it should be resolved in accordance with the operative facts present in each case. In this way, the objectives of Section 16(b) may be served without impermissibly adding to the basically sensible provisions of the statute.

For example, the court below believed that if it failed to draw an absolute rule including the first ten percent purchase, it would permit:

> "an initial purchase of as large a block of stock as 51 percent or more of a corporation's stock, followed by a sale any time within six months by the stockholders who obviously within that period could obtain such inside information and also could influence, manipulate or control corporate transactions." 434 F.2d at 924.

To the extent its reasoning rests on the after-acquired information theory, the unsound basis upon which that theory rests has been set forth in Point 2 *supra.* But the assertion that a shareholder would be able to effect a subsequent manipulation of the corporation's affairs is in conflict with both the distinction drawn by Congress and the reasoning in *Adler* v. *Klawans, supra.* To avoid this problem, the court below hypothesized a situation where the shareholder had acquired complete control—51% of outstanding shares. However, its rationale obviously does not cover cases where control and attendant manipulative ability are lacking.

The issue of control is an issue of fact, the resolution of which is a familiar problem regularly handled by the courts.[30] If it were demonstrated that a shareholder had gained control over the issuer corporation by reason of the purchase or purchases involved, his status would arguably be tantamount to that of an officer or director within the purview of Section 16(b), and would arguably make a defendant's position more difficult. Such supplemental proof is exactly the type of proof required by this Court's decision in *Blau* v. *Lehman, supra.* But in the absence of such proof, there is no basis for blurring the distinctions[31] drawn by Congress in the statute itself, nor for adding to the presumptions in the statute. Certainly, the fundamental fact of the instant case is that the respondent was wholly unable to exercise any control over the issuer's hostile management—who, in fact, sought to nullify the respondent's shareholdings by causing a merger with the petitioner herein.[32]

Other ambiguities exist in the application of the statute. For example, the question of whether transactions resulting from mergers, conversions, exchanges of assets, and similar transactions are "purchases"or "sales" within the purview of Section 16(b) provides no ready answer. These questions are being treated on the basis that a court should

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30. See *e.g.*, Rule 12b-2 (§240.12b-1) issued under the Securities Exchange Act of 1934; *Willheim* v. *Murchison*, 342 F.2d 33, 38-39 (2 Cir.), *cert. denied* 382 U. S. 840 (1965) (Investment Company Act of 1940); 2 Loss, *Securities Regulation* 764-783 (2 ed. 1961.)

31. A distinction on the basis of control has been recognized by the Second Circuit in *Blau* v. *Lamb, supra,* 363 F.2d at 521 n. 19, as follows:

> "[A] noncontrolling 'insider' [shareholder] has the power to misuse inside information for speculative purposes by trading in light of the inside information to which he is privy. A 'controlling insider' also can manipulate corporate activity in order to create favorable short-swing trading situations."

32. No claim is made that any director nominated by Emerson was ever elected to Dodge's board of directors.

first inquire to determine whether a given set of transactions allowed for a possibility of abuse involved of the type at which the statute was aimed so that "purposeless harshness" may be avoided. See, *e.g., Blau* v. *Lamb, supra,* 363 F.2d 507, 519, and cases cited at n. 20, *supra.* Based upon a review of the *facts* of cases involving the statutory exemption for beneficial owners, it would appear that the application of that exemption has been resolved in a similar way. It is the overly broad decisional language that has created difficulties.

If the statutory exemption is unclear, it is an unjustifiable leap to hold that the initial ten percent transaction must always be included. If a wrong is alleged in these ambiguous circumstances, there must be some further proof of it. *Blau* v. *Lehman, supra;* Note, 84 Harv. L. Rev. 1012, 1022-3, n. 30 (1971). In the absence of such proof on the record of this case in connection with either the acquisition or disposition by respondent of its Dodge shares, it should not have been subjected to a harsh liability which does not serve the purposes of the statute.

CONCLUSION

The judgment of the court below should be affirmed insofar as it adjudged respondent not to be liable under Section 16(b), and, if the Court reaches the issue of the initial ten percent transaction, reversed to the extent that it adjudged liability against the respondent.

Respectfully submitted,

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